

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

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, ID No.

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January 03, 2008

TY:

Legend:

Taxpayer =
Company =
Product =
Business =

Indication X =
Indication Y =
Date 1 =
Year 1 =
A =
B =
C =
Period 1 =

Dear :

This letter responds to a private letter ruling request dated October 31, 2007, which was submitted by the authorized representative of Taxpayer. In that letter, rulings were requested concerning certain amounts Taxpayer will receive under an agreement. Specifically, Taxpayer requests a ruling that (1) inclusion of the amounts in gross income in the next succeeding taxable year following the year of receipt is a proper method of accounting, to the extent that the amounts are recognized by Taxpayer in revenues in its applicable financial statement in a taxable year following the year of receipt, pursuant to the deferral method of section 5.02 of Rev. Proc. 2004-34, 2004-22 I.R.B. 991; and (2) Taxpayer may adopt the deferral method in Year 1 because Year 1 is the first year in which Taxpayer receives an advance payment, as defined in section 4.01 of Rev. Proc. 2004-34.

Taxpayer is engaged in Business. Prior to Date 1, Taxpayer owned or controlled certain intellectual property (the IP), including patents and know-how, related to Product. Taxpayer and Company entered into an agreement as of Date 1 (the Agreement), under which Taxpayer granted Company an exclusive license to develop, use, offer for sale, sell, sublicense and otherwise commercialize any products for human use containing Product that are made by a process covered by the IP (licensed products). The license granted to Company was co-exclusive with Taxpayer so that Taxpayer may exercise its rights and perform its obligations under the Agreement. The Agreement provides that Taxpayer and Company will collaborate in developing, marketing, and obtaining regulatory approval for, licensed products. Taxpayer and Company have agreed to bear B percent and C percent, respectively, of the costs of development of the initial licensed product for Indication X and Indication Y. The Agreement also provides guidelines for the allocation of primary responsibility and costs associated with development of other licensed products.

In consideration for entering into the Agreement: (1) In Year 1, Company paid Taxpayer a non-refundable initial license fee (the Fee) of \$A; (2) Company is obligated to make payments to Taxpayer if and when certain milestones in the development of the IP are met (the Milestone Payments); and (3) if licensed products are commercialized, Company is obligated to make payments of royalties to Taxpayer based on the level of sales of the product (the royalty payments).

Taxpayer has represented that the Milestone Payments are solely for the use of the IP and compensate Taxpayer for the increased value of the IP as it progresses through each stage of development, testing, and regulation, and that no part of the Milestone Payments is compensation for services. The royalty payments are not addressed in this ruling.

Taxpayer has a certified audited financial statement, accompanied by the report of an independent CPA, which is used for credit purposes, reporting to shareholders, and other substantial non-tax purposes, and is an applicable financial statement as defined in section 4.06(2) of Rev. Proc. 2004-34. Taxpayer anticipates that it will recognize the Fee in revenues in the applicable financial statement over Period 1, rather than in the year of receipt. Taxpayer received no advance payments, as defined in section 4.01 of Rev. Proc. 2004-34, prior to Year 1. Taxpayer anticipates that current financial reporting rules will require it to recognize the Milestone Payments in income in the taxable year of receipt, but will include the Milestone Payments in income in its applicable financial statement in a subsequent taxable year to the extent financial reporting rules permit.

Section 451(a) of the Internal Revenue Code provides that the amount of any item of gross income is included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used by the taxpayer in computing taxable income, the amount is to be properly accounted for as of a different period.

Section 1.451-1(a) of the Income Tax Regulations provides that, under an accrual method of accounting, income is included in gross income when all the events have occurred that fix the right to receive the income and the amount can be determined with reasonable accuracy. All the events that fix the right to receive income generally occur when (1) the required performance takes place, (2) payment is due to the taxpayer, or (3) payment is received by the taxpayer, whichever happens earliest. Rev. Rul. 84-31, 1984-1 C.B. 127.

Section 5.02(1)(a) of Rev. Proc. 2004-34 provides that a taxpayer within the scope of the revenue procedure that chooses to use the deferral method described in that section is using a proper method of accounting under § 1.451-1. A taxpayer using the deferral method must include an advance payment in gross income in the taxable year of receipt to the extent recognized in revenues in its applicable financial statement in that year, and include the remaining amount of the advance payment in gross income in the next succeeding taxable year.

Section 4.01(3) of Rev. Proc. 2004-34 provides that a payment received by a taxpayer for the use (including by license or lease) of intellectual property is an advance payment if including the payment in gross income for the taxable year of receipt is a permissible method of accounting for federal income tax purposes (without regard to the revenue procedure) and the payment is recognized by the taxpayer (in whole or in part) in revenues in its applicable financial statement for a subsequent taxable year.

Section 4.03 of Rev. Proc. 2004-34 provides that the term intellectual property includes patents and similar intangible property rights.

Section 4.06(2) of Rev. Proc. 2004-34 defines an applicable financial statement to include a certified audited financial statement that is accompanied by the report of an independent CPA that is used for credit purposes, reporting to shareholders, or any other substantial non-tax purpose.

Section 8.01 of Rev. Proc. 2004-34 provides that a taxpayer may adopt any permissible method of accounting for advance payments for the first taxable year in which the taxpayer receives advance payments.

Based on the language of the Agreement and Taxpayer's representations, we conclude that the Fee and the Milestone Payments are payments for the use of intellectual property and are advance payments within the meaning of section 4.01 of Rev. Proc. 2004-34, to the extent the Taxpayer recognizes the payments in its applicable financial statement for a taxable year following the taxable year of receipt. Therefore, we conclude that, under section 5.02 of Rev. Proc. 2004-34, it is a proper method of accounting for Taxpayer to defer to the next succeeding taxable year following the year of receipt the inclusion in gross income of the Fee and each Milestone Payment to the extent that the Fee and each Milestone Payment are recognized by Taxpayer (in whole

or in part) in revenues in its applicable financial statement for a taxable year subsequent to the taxable year of receipt. Because Year 1 is the first taxable year in which Taxpayer receives an advance payment, Taxpayer may adopt the deferral method of section 5.02 of Rev. Proc. 2004-34 in Year 1, pursuant to section 8.01 of Rev. Proc. 2004-34.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Donna M Crisalli
Senior Technician Reviewer, Branch 2
(Income Tax & Accounting)

cc: